

# Yen 4Sight

## Highlights

- The further jump in the yen since the UK referendum adds to the case for extra policy action from the BoJ.
- The strong yen has been importing deflationary pressure and squeezing exporters' margins. Surveys are downbeat.
- Inflation data due Friday will show further declines in all key measures in May while the BoJ Tankan due the same day will likely be consistent with tepid growth at best.

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### Interest and exchange rate forecasts

End period	28-Jun	Q316	Q416	Q117
BoJ ONR %	-0.1	-0.2	-0.2	-0.3
BoJ JGBs ¥trn	320	340	360	380
10Y JGB %	-0.22	-0.25	-0.25	-0.30
JPY/USD	103	100	100	102
JPY/EUR	114	108	108	114

Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

## Sky-high yen sends alarm bells ringing

Long before the UK referendum result shocked investors firmly into risk-off mode sending the yen briefly to ¥99/\$ – up more than 20% from the start of the year – the exchange rate had become a major source of consternation for Japanese policymakers and firms alike. In terms of inflation, the yen has been weighing directly and heavily on prices of imported goods, which overall were down more than 20%Y/Y in May, with prices of imported consumer goods down more than 9%Y/Y – a sizeable deflationary impulse in the CPI pipeline. The impact of the strong yen on export prices has been no less marked, resulting in a significant squeeze on exporters' margins. While in contract-currency terms export prices were down 4.5%Y/Y in May, in yen terms they were down more than 11%Y/Y, the most since 2009. Moreover, while the significant depreciation from late 2012 through to mid-2015 was not accompanied by any meaningful increase in Japan's share of global goods imports, the loss of competitiveness associated with recent sharp yen appreciation might still result in a renewed erosion of market share as occurred between 2007 and 2012. And it also risks dampening spending by foreign visitors, a significant recent source of economic growth.

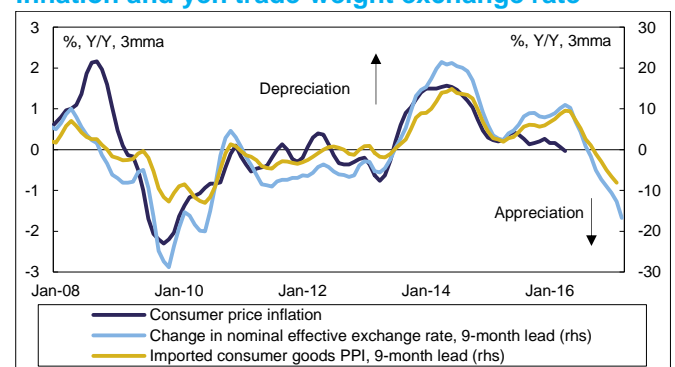
## Headline trade balance back in deficit

Indeed, May's goods trade report displayed many signs of recent yen strength. After April brought the largest surplus since 2010 at more than ¥800bn, there was payback in May as the balance shifted back into deficit for the first time since January, to the tune of about ¥40bn. The value of exports dropped more than 11%Y/Y, with further double-digit percentage declines to the US, China and the rest of Asia. The value of machinery exports fell almost 9½%Y/Y and those of iron and steel fell 24%Y/Y. Meanwhile, the value of imports fell 13%Y/Y, with the value of petroleum imports down by almost one third.

## Detail of trade report not quite so alarming

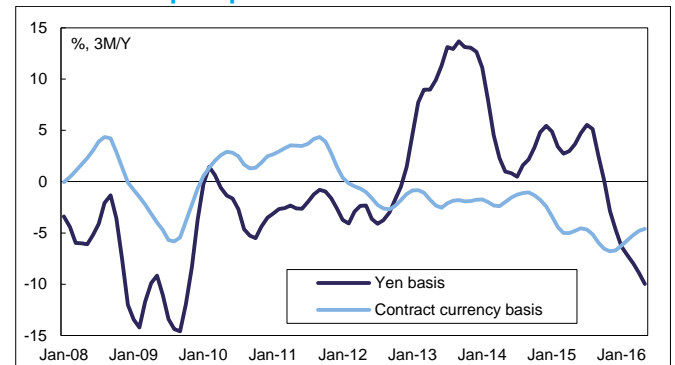
On a seasonally adjusted basis, however, the trade surplus fell only about ¥130bn to ¥270bn, seemingly leaving the underlying positive trend intact. Meanwhile, adjusting for the massive price shifts, the volume of exports was up more than 3%Y/Y and little changed from April on the BoJ's figures. On the same basis, the volume of imports was up almost 3%Y/Y and 5%M/M, with the jump in the latest month only partly reversing a cumulative decline over the preceding two months. As a result, while the

## Inflation and yen trade-weight exchange rate



Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

## Producer export prices



Source: BoJ and Daiwa Capital Markets Europe Ltd.

## Export market share and yen exchange rate\*



\*Japanese export volumes as a share of global import volumes. Source: CPB, BIS and Daiwa Capital Markets Europe Ltd



volume of exports has been little changed so far on average in Q2 and supported by a stronger showing to Europe offsetting weakness to other major markets, imports have been significantly weaker, down on the same basis by more than 2%. So, despite appropriate concerns about the impact on competitiveness from the strong yen, while net trade might yet subtract from GDP growth in Q2 for the first quarter in a year, based on last week's figures a neutral or even small positive contribution cannot be ruled out.

### A (seemingly) firm start to Q2 for economic activity

Indeed, in some ways, other recent Japanese economic data have been as strong as might reasonably have been expected. While it was flattered by the leap-year effect, GDP growth of 0.5%Q/Q in the first quarter was the firmest in a year and not to be sniffed at. And at face value, most monthly data suggest a solid start to the second quarter too, e.g. household spending on core items jumped almost 3%M/M in April, while the Cabinet Office's synthetic consumption index was up on a three-month basis by almost 1%, the most since March 2014. Moreover, the all-industry activity figures for April confirmed that all main production sectors of the economy started the second quarter on the front foot. While industrial output posted a second successive monthly gain, up 0.5%M/M, tertiary activity was up 1.4%M/M, the most in more than two years. And construction firms had a particularly fruitful month, with output up 2.4%M/M, the most since January. Indeed, construction activity was solid across the private and public sectors and in residential and non-residential work alike. And as illustrated by new housing starts, up more than 9%Y/Y in April, the near-term outlook for residential construction remains positive too.

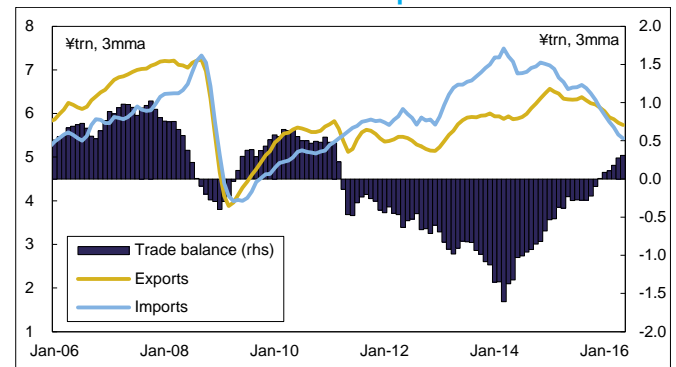
### April to represent Q2's high-water mark

In sum, all-industry activity in April rose 1.3%M/M, the most since just before the last consumption tax hike to a level 1.1% above the average of the first quarter. And the three-month growth rate reached 0.3%3M/3M, by no means vigorous but still the highest in a year. However, with the exception of construction, the level of output was still subdued, with all-industry activity less than 3% above where it was at end-2012 when Abe took office and 1½% below the pre-consumption tax hike peak. And consistent with that sluggish trend of the past couple of years, there seems a good chance that April will represent the high-water mark for the second quarter. Indeed, while the bulk of May's economic data are due at the end of this week, the few indicators for that month released already suggest a weakening in the middle of the second quarter.

### Department store sales disappoint in May

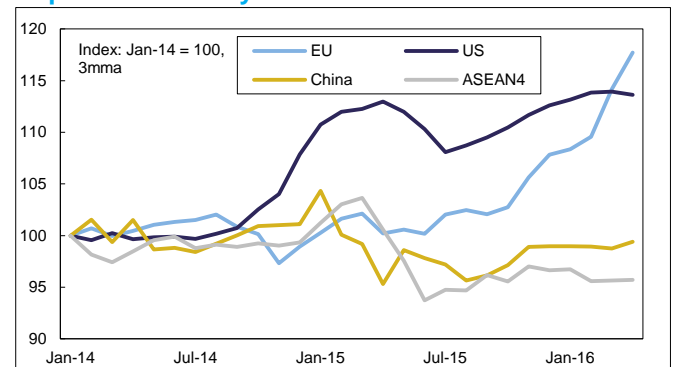
The latest store sales figures were certainly disappointing, reinforcing expectations of a pull-back in consumption following the firmer start to the quarter and thus seemingly consistent with a return to the moribund norms of the past couple of years. To some extent, calendar effects weighed on sales in May. But even accounting for that, the figures appeared to offer little cheer. On an unadjusted basis, national department store sales fell more than 5%Y/Y in May, with the weakness reportedly at least in part due to reduced spending from overseas visitors, in which the strong yen might have played a role. In addition, the

### Goods trade balance and components\*



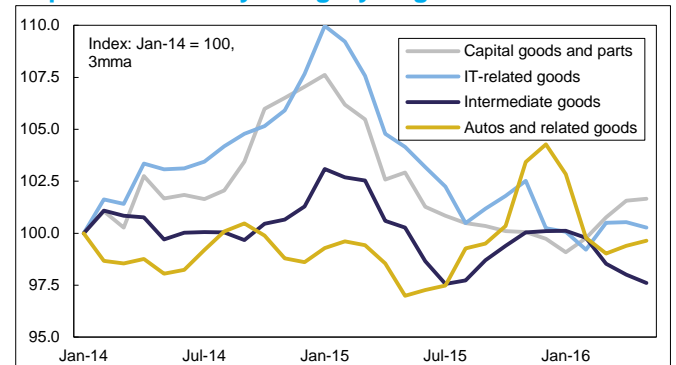
\*Seasonally adjusted basis. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

### Export volumes by destination



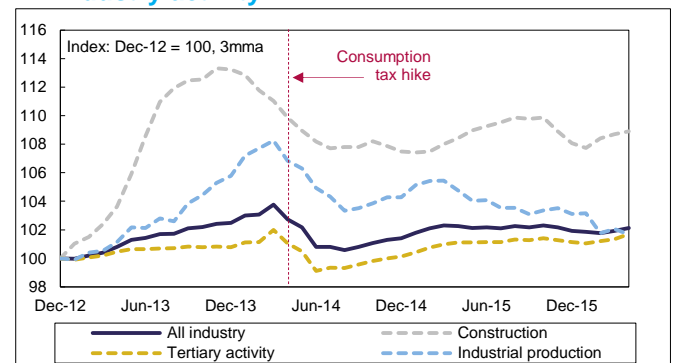
Source: BoJ and Daiwa Capital Markets Europe Ltd.

### Export volumes by category of good



Source: METI and Daiwa Capital Markets Europe Ltd.

### All industry activity



Source: METI and Daiwa Capital Markets Europe Ltd.

annual comparison for apparel sales was negatively affected by more favourable weather a year earlier. And chain store and convenience stores alike saw annual declines.

### Manufacturing PMI points to a weaker end to Q2

Surveys also point to a softening of activity over the remainder of the second quarter. June's flash manufacturing PMI came in at 47.8, consistent with contraction in the sector and up just 0.1pt from May's reading, which was the lowest since January 2013. The survey detail signalled a continued negative trend in output, new orders and new export orders, albeit not quite as marked as in the previous month. And the survey also suggested a weaker pace of employment growth in the sector and more intense downward pressure on output prices, similarly by the most since January 2013. So, although manufacturing production started the second quarter on a firmer note, subsequent months look likely to have been weaker and – with the strong yen and continued subdued external demand prime concerns – the near-term outlook for the sector hardly provides cause for optimism either.

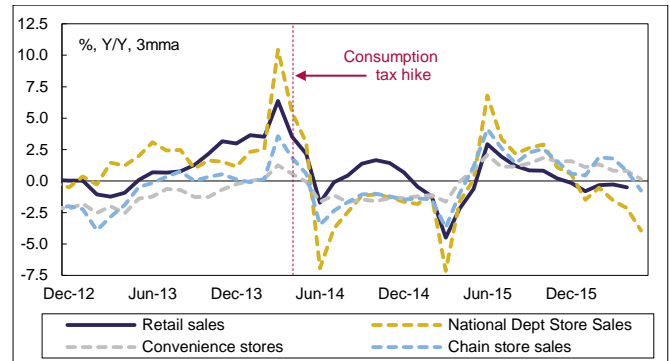
### Reuters survey points to a downbeat Tankan too

The latest Reuters Tankan survey results also suggested that manufacturing sentiment remained downbeat in June, improving only very slightly from May's three-year low. And the equivalent measure for the non-manufacturing sector was discouraging too, slipping to its lowest since April 2013. And while the forward-looking survey components flagged the likelihood of a very modest improvement in the coming quarter, overall this survey – which provides a useful guide to the BoJ's all-important quarterly Tankan due on Friday – suggests that business conditions are likely to remain consistent with nothing better than tepid economic growth over the near term. Given the ongoing deflationary impulse from the strong yen, that would seem to further underscore the diminished likelihood that the BoJ will meet its inflation target for the foreseeable future. And while the ongoing downward shift in the JGB yield curve in the past week to new record lows might point to a continued easing of financial conditions, further incremental policy action from the BoJ – in terms of a further modest cut in the policy rate – might seem in order too.

### This week in Japan

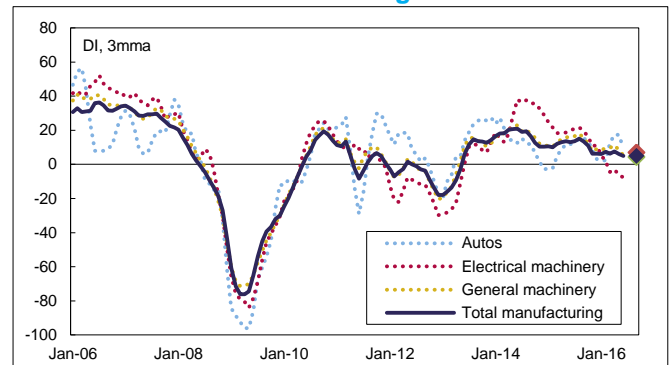
While the start of this week has been quiet for economic data, the back end will be very busy. May retail sales figures are due on Wednesday with industrial production, housing starts and construction orders figures for the same month due the following day. And Friday will be chock-full of new data, with the latest quarterly BoJ Tankan results due along with the latest monthly data for inflation, household spending, the labour market and consumer confidence. Among these figures, the Tankan is likely to signal a deterioration in business conditions in the second quarter with little improvement anticipated in the third quarter. In addition, inflation is likely to have fallen further, e.g. with core CPI (excluding fresh food) down to a more than three-year low of -0.4%Y/Y with the BoJ's new preferred core measure (excluding fresh food and fuel) declining further below 1%Y/Y.

### Retail and selected store sales



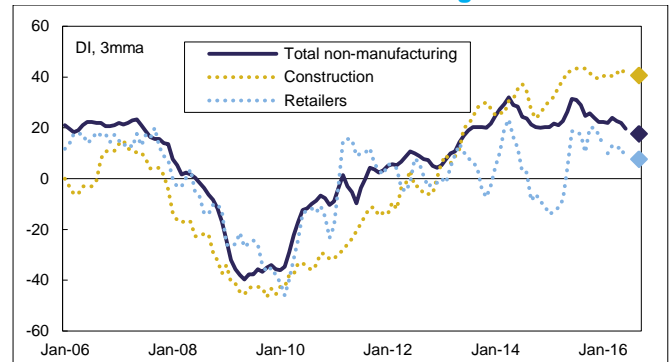
Source: Thomson Reuters, Bloomberg and Daiwa Capital Markets Europe Ltd.

### Reuters Tankan: Manufacturing conditions\*



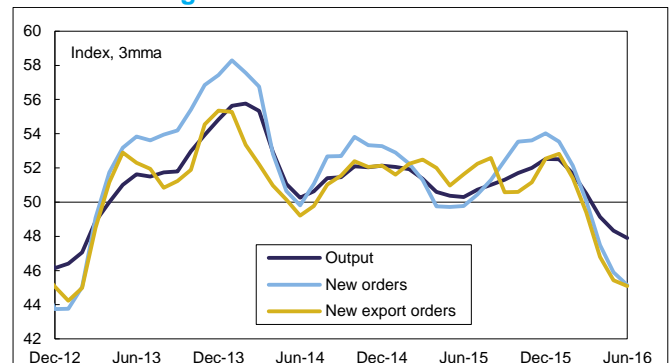
\*Diamond represents survey forecast for September 2016, 3mma.  
 Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

### Reuters Tankan: Non-manufacturing conditions\*



\*Diamond represents survey forecast for September 2016, 3mma.  
 Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

### Manufacturing PMIs\*



\*Flash estimates for June 2016. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

# Economic calendar

## Key data releases – June/July

20	21	22	23	24
GOODS TRADE BALANCE ¥BN APR 397 MAY 270	AUCTION FOR ENHANCED LIQUIDITY  ALL INDUSTRY ACTIVITY M/M% MAR 0.2 APR 1.3 REUTERS TANKAN – LARGE MANUFACTURERS DI MAY 2 JUN 3 LARGE NON-MANUFACTURERS DI MAY 19 JUN 17		3M TB AUCTION 20Y JGB AUCTION  MANUFACTURING PMI MAY 47.7 JUN P 47.8 COINCIDENT INDEX MAR 110.2 APR F 112.0 LEADING INDEX MAR 99.1 APR F 100.0	SERVICES PPI Y/Y% APR 0.3 MAY 0.2  BOJ SUMMARY OF OPINIONS (15-16 JUNE 2016 MEETING)
27	28	29	30	01
	2Y JGB AUCTION (APPROX ¥2.3TRN)	RETAIL SALES Y/Y% APR -0.9 MAY -1.6	3M TB AUCTION (APPROX ¥4.4TRN)  INDUSTRIAL PRODUCTION Y/Y% APR 0.5 MAY -0.2 HOUSING STARTS Y/Y% APR 9.0 MAY 4.9 CONSTRUCTION ORDERS Y/Y% APR -16.9 MAY N/A	BOJ TANKAN SURVEY – LARGE MANUFACTURERS DI Q1 6 Q2 4 LARGE NON-MANUFACTURERS DI Q1 22 Q2 19 NATIONAL CPI Y/Y% APR MAY -0.3 -0.5 <i>EX FRESH FOOD</i> -0.3 -0.4 <i>EX FOOD/ENERGY</i> 0.7 0.6 <i>EX FRESH FOOD/ENERGY</i> 0.9 0.9 TOKYO CPI Y/Y% MAY JUN -0.5 -0.4 <i>EX FRESH FOOD</i> -0.5 -0.5 <i>EX FOOD/ENERGY</i> 0.5 0.4 UNEMPLOYMENT RATE % APR 3.2 MAY 3.2 JOB-TO-APPLICANT RATIO APR 1.34 MAY 1.35 HOUSEHOLD SPENDING Y/Y% APR -0.4 MAY -1.0 VEHICLE SALES Y/Y% MAY 6.6 JUN N/A CONSUMER CONFIDENCE MAY 40.9 JUN 41.0 MANUFACTURING PMI MAY 47.7 JUN F 47.8
04	05	06	07	08
MONETARY BASE (JUN)	10Y JGB AUCTION  SERVICES PMI (JUN) COMPOSITE PMI (JUN)	6M TB AUCTION	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY  COINCIDENT INDEX (MAY P) LEADING INDEX (MAY P)	AVERAGE WAGES (MAY) ECONOMY WATCHERS SURVEY (JUN) BANK LENDING (JUN) CURRENT ACCOUNT BALANCE (MAY)
11	12	13	14	15
MACHINE ORDERS (MAY) M3 MONEY SUPPLY (JUN)	30Y JGB AUCTION  TERTIARY ACTIVITY (MAY) PPI (JUN)	INDUSTRIAL PRODUCTION (MAY F) CAPACITY UTILISATION (MAY)	3M TB AUCTION 5Y JGB AUCTION	

Source: BoJ, MoF, Bloomberg & Daiwa Capital Markets Europe Ltd.

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